

CEPS WORKING DOCUMENT

*Thinking ahead for Europe*

The Mercosur–EU Preferential Trade Agreement A view from Europe

Patrick Messerlin

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Abstract

This paper first aims at assessing the economic and political importance of Mercosur for the EU's interests in the short and medium run – say for the one or two coming decades or so. As Mercosur's size is largely determined by Brazil's size, this paper focuses on Brazil – although the paper assumes that, from Brazil's perspective, a Brazil–EU preferential trade agreement (PTA) is a non-starter. It then aims at positioning the Mercosur–EU (MEU) PTA in the context of the EU's current trade policy. In particular, it tries to assess, once one takes into account all the crucial goals to be met by the EU, whether the EU is likely to find the time and the resources necessary for dealing properly with a MEU PTA; this effort is notably complicated by the very divergent views on the role of trade between Brazil on the one hand, and Argentina and Venezuela, on the other hand. Finally, the paper examines the PTA options that can be seen as reasonably feasible. It suggests that, unless there are dramatic changes in Mercosur's present trajectory, the goal of negotiating a fully-fledged MEU PTA should be set aside for some time – at least a decade or so. This does not mean leaving the negotiating table, but rather focusing on negotiating topics that remain attractive to both sides in the current context, and manageable and flexible enough to overcome the broad general problems confronted by Mercosur and the EU.

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Contents

Introduction.....	1
1. Mercosur and Brazil viewed from the EU.....	1
<i>A broad political perspective.....</i>	<i>1</i>
<i>Economic attraction</i>	<i>2</i>
2. Positioning the MEU PTA in the EU's current policy context.....	4
3. What should be done?	5
<i>Identifying the topics to keep on the negotiating table.....</i>	<i>6</i>
<i>Identifying the most efficient instruments of negotiation.....</i>	<i>7</i>
Concluding remarks	9
References.....	10

The Mercosur–EU Preferential Trade Agreement: A view from Europe

Patrick Messerlin*

CEPS Working Document No. 377 / February 2013

Introduction

This paper examines the likelihood of a preferential trade agreement (PTA) between Mercosur and the EU, and its possible content. The term PTA, adopted by the related WTO report (WTO, 2011) is preferred to ‘free trade agreement’ (FTA) for two reasons. First is that the content of the 350 (notified to the WTO) to 550 (allegedly signed) FTAs does not qualify automatically for the ‘free trade’ term. Most of these FTAs have very poor market access provisions for trade in goods, and often none or WTO-minus levels for trade in services (Adlung and Miroudot, 2012) or concerning topics (non-tariff barriers, investment, public procurement, etc.) that are an integral part of 21st century trade agreements. The second reason is that one of Mercosur’s economies – Brazil – is large enough in some sectors to have some impact on world prices. A trade agreement with another large economy, such as the EU, has the potential to generate notable discriminatory effects on the economies of the rest of the world. In such a context, the term ‘preferential’ is a useful reminder that PTAs among large economies may increase trade among the signatories, but to the detriment of trade between the signatories and the rest of the world.

1. Mercosur and Brazil viewed from the EU

From the EU perspective, the importance of Mercosur is largely related to the importance of Brazil, particularly since Argentina has shifted to a strongly protectionist stance – hence offering little, if any, prospect for fulfilling the EU’s general demand of deeper market access. The importance of Brazil for the EU can be measured in two ways.

A broad political perspective

From a broad political perspective, Brazil is one of the few important emerging economies with which the EU should interact on a permanent basis. This is because Brazil has been successful at establishing itself firmly as a key ‘voice’ of the emerging and developing economies in the trade and economic debates since the mid-1990s, and even more so since the early 2000s. This new Brazilian approach started in 1995 when Brazil dropped its uncompromising tone with respect to the Uruguay Round, allowing its successful conclusion.

In the 2000s, it was clear that no deal in the Doha Round could be done without Brazil’s support. Brazil’s positions in the Doha negotiations were essential in many instances for the EU because Brazil was suggesting some concessions from the emerging and developing countries (compared with the more radical Indian views and the more cryptic Chinese positions), while the EU was trying to do the same on the side of industrial countries

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(compared with the more radical US views). This relatively 'centre' position of Brazil has had the same appeal for the EU on issues other than trade, such as climate change or security.

There are difficulties, however, with sustaining the tough but constructive dialogue between Brazil and the EU during the active years of the Doha Round, given the failure of the round in June 2008 and the economic crisis since then.

- In Brazil, the balance between offensive and defensive interests has clearly shifted in favour of the latter under President Dilma Rousseff's administration, not only for purely domestic reasons but also because of the increasing pressures of the anti-trade approach followed by Argentina and Venezuela.
- In the EU, the economic and monetary crisis has captured the full attention of the top decision-makers, leaving trade a frozen issue on a sidetrack – with no additional market opening but no substantial protectionist measures – until recently.

Still, recent months have witnessed a widening gap between Mercosur and the EU. On the Mercosur side, the drift towards protection continues, which has even de facto gone farther when such issues as trade and exchange rates have been put on the table. By contrast, in late November 2012, the Council's decision to give a mandate to the European Commission for negotiating a PTA with Japan suggests a drastic change of approach by the top EU policy-makers to PTAs. But it must be stressed that this change of approach focuses on the US, Japan, Taiwan and China – all economies much larger, directly or indirectly, than Brazil's. The other EU trade initiatives, such as the recent launch of the trade negotiations with Thailand, remain largely driven by the European Commission, with little interest from most EU member states, except when some narrow and key offensive or defensive vested interests of EU member states are involved (a situation that often creates sharp intra-EU conflicts during the last moments of a trade negotiation).

Economic attraction

This economic size factor deserves more attention. The fading of the EU's political attraction to Brazil could be countervailed by economic forces. Yet in this respect, there are forces pulling in other directions, which, once combined, suggest that Brazil is not so high up on the EU's economic and trade agenda.

On the one hand, the economic crisis requires that the EU opens its markets in priority to economies that fulfil three conditions: they have to be very large, well regulated and well connected with the rest of the world by being the "hub" of PTAs (Messerlin, 2012). Only such economies have the necessary weight and energy to attract the huge if stuck EU-27 train, because they offer in scale and scope economies that are large and deep enough to have an impact on domestic relative prices in the EU. (Economic analysis shows that relative prices are what determine the comparative advantages of the trading partners, and thus the gains from trade.)

Table 1 shows that, in the early 2010s, Brazil does not look like the most attractive country with respect to these three conditions. Its GDP represents only 11% of the EU's GDP, much behind that of the US (86%), China (36%) and Japan (34%). Moreover, during the next two decades, Brazil is not expected to increase substantially its share of world GDP, meaning that there are more dynamic – hence attractive – economies for the EU. Not surprisingly, all these more attractive economies are located in East Asia, and – *en passant* – they are the industrial locomotives needed by resource-rich Brazil. Lastly, Brazil's ranking in terms of governance is much behind that of the US, Japan and Taiwan. For the sake of comparison, Table 1 provides similar information on two countries (India and Russia), which are today the same size as Brazil.

Table 1. Brazil's relative attractiveness

	EU market expansion (% EU GDP)		Regulatory quality		"Hub" quality
	2010	2030	[a]	[b]	
	1	2	3	4	5
EU	100.0	100.0	5 to 100	2 to 83	Korea, Turkey
Korea	6.3	6.7	8	22	EU, US, ASEAN, China
Brazil	12.9	23.5	126	58	Argentina
India	10.7	49.7	132	51	
Russia	9.1	20.2	120	63	
Japan	33.9	36.1	20	6	ASEAN
Taiwan	2.7	7.6	25	13	China, NZ, Singapore
Chiwan	5.1	14.6	(na)	(na)	(China)
China	36.2	168.6	91	27	Taiwan, ASEAN

Notes: Chiwan refers to Taiwan GDP and GDP arising in China through Taiwanese firms. In the table, [a] and [b] refer to country rankings: the higher the country's rank, the poorer is its regulatory performance. Category [a] is the ease of doing business (Doing Business, 2012); [b] is the Overall Index, Global Competitiveness Index (World Economic Forum, 2011) (sources: Buiter and Rahbari (2011) for growth estimates and WTO Trade Profiles for the GDP of the individual countries and regions; author's calculations).

Sources: Adapted from Messerlin (2012).

On the other hand, Brazil is large enough to be a major international actor in some sectors: agriculture, raw materials and a few industrial sectors, including some that are intensive in highly skilled labour, such as aircraft. Even so, this sectoral importance does not create a situation propitious to the negotiations on a PTA with the EU for the following reasons:

- The offensive interests in the EU that would be attracted to trade negotiations with Brazil are limited to a few sectors where Brazil has traditionally strong protectionist or opposite interests: manufacturing, investment, public procurement, intellectual property rights, etc.
- The defensive interests in the EU against Brazil's comparative advantages are also limited and concentrated in some EU member states, as best illustrated by the EU's agricultural sector. The absence of top EU policy-makers ready to give strong support to a MEU PTA gives a lot of power to these vested interests, even if they are tiny, as demonstrated by the many years of negotiations with little progress on tariff quotas in beef or other narrowly defined farm products.
- Finally yet importantly, some defensive interests in Brazil are closely connected with key EU firms, as shown by the car industry. Indeed, some EU member states have crucial defensive interests in Brazil as well as in the EU – a relatively rare occurrence in the world trade system. This is the case of France, with the opposition of some (not all) French farm vested interests protected by the common agricultural policy and of French carmakers happy to operate in Brazil behind high tariffs.

In sum, the political economy of trade negotiations in the EU leave little hope for achieving meaningful results from negotiations on a fully-fledged MEU PTA.

2. Positioning the MEU PTA in the EU's current policy context

Trade policies are matters to be assessed in relative terms. It could have been the case that the EU's political and economic attraction to Brazil/Mercosur might have been limited, but there was not a more attractive region than Mercosur in terms of trade policy for the EU. But that is not the case. Indeed, the EU has a few other, more attractive negotiating options that will be very intensive in time and human resources. In other words, the EU will have to set priorities. What follows argues that a MEU PTA does not pertain to the likely set of priorities.

Everything flows from the fact that the Doha Round is stuck. The key question is for how long. The answer to this question depends upon the causes for this stalemate: they are so many and diverse that optimism is not on the agenda.

First, the Doha stalemate is related to trade issues. There are plenty of candidates for such an explanation: the existing agreements on the general formulas of liberalisation in manufacturing and agriculture are unfinished business, the exceptions to these formulas are only sketchy, there has been no serious examination of the liberalisation in services, and there is a host of topics – such as trade facilitation, duty-free, quota-free and other rules – that may look easy and close to a deal at first glance but which have ended up as a source of deep disagreements in the bitter and tense mood presiding over the Doha negotiations since June 2008.

Second, the Doha stalemate is not so much about trade issues as the vision of international governance – that is, a much deeper and wider cause. The June–September 2008 period revealed the fundamental opposition between the US and China. The US view is that the emerging economies – China being the first – should abide by the same rules as the developed countries, and that these rules and disciplines should be ‘strengthened’ – meaning that they should be much more similar to US rules and regulations than the current WTO disciplines. In sharp contrast, China, followed by all the emerging economies, argues that the current WTO regulations are quite adequate for the emerging countries, including the ‘special and differentiated treatment’ provision (the *bête noire* of US trade policy since the early 1990s).

In this context, the Trans-Pacific Partnership (TPP) should be perceived as an attempt by the US to create a ‘WTO version 2.0’ that is much more favourable to its views than the current WTO. Indeed, it is interesting to note that Susan Schwab (the US trade representative in 2008), who had the authority to strike a deal at the 2008 WTO ministerial but left the negotiating table in June 2008, made the US pivot towards East Asia in September 2008 when she announced US intentions to join and lead the TPP.

The second cause (global governance) suggests that the Doha Round is going to be in a coma for a long time. Such a situation opens the door to a totally new game in the world trade regime – the emergence of ‘mega PTAs’. The largest world economies (China, the EU, Japan and the US) are starting to look for bilateral PTAs among themselves in order to harness their domestic growth on larger, more dynamic markets that are better regulated. This is a decisive shift away from the usual PTAs, which have been largely limited to bilaterals between a large/very large economy and much smaller economies (Messerlin, 2013). It introduces an additional motive for the EU to focus on PTAs with countries like Japan or Taiwan: such PTAs offer the best insurance policy against a successful Trans-Pacific Partnership and a successful China–Japan–South Korea PTA.

Combining the ‘growth’ argument of section 1 (the necessity for the EU to focus on large, dynamic and well-regulated trading partners in order to boost its growth) and the ‘insurance’ argument (the dramatic shift of the world trading system to mega PTAs among

large economies) leads to one strong conclusion for the EU: for the decade to come, in addition to an EU-US PTA, the EU should concentrate its trade negotiating strategies on two PTAs – Japan-EU and Taiwan-EU (the attraction of the latter being related to the links between Taiwan and mainland China) (Messerlin, 2012).

This conclusion relies also on three additional factors:

- The first is largely based on political economy aspects. Only these three PTAs (four with a China-EU PTA) will be able to attract the attention of the top decision-makers in Europe, hence to evade the risks of being captured by relatively small lobbies. No EU head of state or government will neglect a PTA with these three countries.
- The second argument is technical. One should realise how complex such negotiations will be if one wants to have the expected pro-growth impact of PTAs on EU domestic growth. These three PTAs have to be truly deep and comprehensive, and hence to address very difficult issues that, for many of them, have never been solved satisfactorily in existing PTAs (including in the EU internal market, the archetypal PTA): mutual recognition in norms for goods and in market regulations on services, the right legal framework for intellectual property rights, state-owned enterprises, investment rules, etc.
- Finally yet importantly, these PTA negotiations will be sequential – not concomitant like those in the WTO forum. In other words, negotiators for the Japan-EU PTA should care about the negative consequences of this PTA on the South Korea-EU PTA, so that EU and Japanese firms investing in South Korea are not hurt by discriminatory provisions of the Japan-EU PTA. Similarly, negotiators of a Taiwan-EU PTA should keep in mind future negotiations on a China-EU PTA – a must if the Doha Round is stuck for years (because China will then be the world's largest economy, and the EU will be smaller in relative terms, the EU will need to harness its growth to the large Chinese economy).

In this context, the EU's fragile decision-making process will have a hard time to devote all the needed attention in the years to come to negotiations on PTAs with countries, such as Brazil (or India), that are dragging their feet and that will become truly attractive in economic terms to the EU only within a couple of decades – when Brazil (or India) will eventually be big, dynamic and better regulated enough, compared with the EU economy. It is only then that these countries will attract the attention they deserve from the EU's top decision-makers, and hence they will escape the risks of being captured by a few of the EU's offensive interests as well as being fought by a few of its defensive ones.

3. What should be done?

If a successful, fully-fledged MEU PTA is out of reach, what then should be done? A first option would be to suspend the negotiations, as was done in 2004. This option is not satisfactory because it leaves the ground free for the powerful protectionist forces in Mercosur. It assumes that Brazil will not be exposed to the 'growth' and 'insurance' arguments that are driving EU trade policy, and that it will be only driven by its Mercosur strategy. That may be the case – and protectionist vested interests in Brazil will certainly push for a strong Mercosur focus. But, it may also be the case that Brazil wants to insure itself against the emerging mega PTAs. In particular, the TPP includes countries that are efficient exporters of agricultural products and of commodities – and thus have the capacity to make life very difficult for Brazilian exports to Japan, for instance. In this scenario, Brazil would look with increasing favour upon a fully-fledged MEU PTA.

This section looks at the alternative option: What are topics for which negotiations could continue with a good chance of being concluded successfully, and thereby prepare a return to the table of negotiations on a fully-fledged MEU PTA in the coming decade or so?

Answering this question requires a method aimed at identifying the topics that should remain on the negotiating table, and it requires some attention to be paid to the negotiating process per se, that is, to the choice of the most efficient instruments of negotiation.

Identifying the topics to keep on the negotiating table

Column 1 of Table 2 lists the topics that seem out of reach in the current context. It includes all those closely related to trade and to market access, such as tariff cuts or disciplines on export barriers. Since the Mercosur countries have presently lost interest in market opening as a support policy for their growth, these topics should be dropped and postponed until the appropriate time when both parties are ready for negotiations on them with a serious chance of economically meaningful results. Trying to get a few tariff cuts here and there, often under the economically unsound form of tariff quotas, is likely to have little positive economic impact. By contrast, it is likely to have big and negative political effects, since any disturbance in the sectors subjected to these complicated aspects of liberalisation would be systematically attributed to the liberalisation by the protectionist lobbies, even if the liberalisation was insignificant ('reluctant' liberalisation relying on complicated mechanisms is self-defeating).

That said, column 1 includes investment because what has recently happened to foreign firms running businesses in Mercosur (from oil in Argentina to retail trade in Venezuela) leaves few doubts that this topic is not on the negotiating agenda. Still, as investment is not a Mercosur competence, it remains a possible area of negotiations between the EU and some members of Mercosur. The same observation could be made for trade in services. It would be useful to review the list of services in order to see whether bilateral agreements between some Mercosur countries and the EU in some services could be envisaged.

Table 2. Identifying topics to keep on the table of negotiations

Trade topics focusing on market access	Non-trade topics often included in "comprehensive economic and trade agreements"		Trade topics preparing market access
1	2		3
Industrial tariffs & equivalents	Anti-corruption	Information society	Customs administration
Agricultural tariffs & equivalents	Approximation of legislation	Labour market regulations	Technical barriers to trade
Export taxes & equivalents	Audiovisual	Mining	Sanitary & phytosanitary measures
Antidumping & Safeguard	Civil protection	Money laundering	Industrial cooperation
Countervailing measures	Consumer protection	Nuclear safety	Research and technology
State trading enterprises	Cultural cooperation	Political dialogue	Environmental laws
Competition policy	Data protection	Public administration	Financial assistance
State aid	Economic policy dialogue	Regional cooperation	Visas for workers
Public procurement	Education and training	Small and medium enterprises	
Intellectual Property Rights	Energy	Social matters	
Trade in services agreement *	Health	Statistics	
Trade-related investment measures *	Human rights	Taxation	
Investment & movement of capital *	Innovation policies	Terrorism	
	Illicit drugs	Visa for asylum, illegal immigration	

Note: Topics followed by an asterisk could be the subject of negotiations between the EU and some Mercosur members.

Source: Adapted from Horn et al. (2009).

Column 2 of Table 2 lists all the topics at the ‘periphery’ of trade matters that are systematically tabled in the context of a ‘comprehensive’ economic and trade agreement negotiated by the EU. It is a long list of items of a very different nature, often political (and indeed politically sensitive) – from illegal immigration to corruption to human rights. The absence of a fully-fledged PTA between Mercosur and the EU, and the current inward-looking political mood in many Mercosur countries are likely to make the negotiations on these topics awkward and unsuccessful. Once again, however, the fact that almost all of these topics are not under Mercosur’s exclusive competence leaves the possibility of bilateral agreements on certain of these topics between the EU and the interested Mercosur members.

Finally, column 3 of Table 2 presents the topics that seem to be the best candidates for successful negotiations in the current context. All of them are characterised by three main features:

- they are useful whether market access is limited or not,
- they are very important for making any future market access liberalisation truly meaningful, and
- they are not under Mercosur’s exclusive competence, and hence offer a degree of flexibility allowing the willing Mercosur members to go ahead.

This list is composed of two very different elements. First are topics related to ‘norms’, such as sanitary and phytosanitary measures for agricultural products, norms and standards (technical barriers to trade) for industrial goods (and regulations in services if some services pass the test of interest at this stage of the EU–Mercosur relations). They are also related to domestic good governance – another way to prepare an economically sound, fully-fledged trade agreement. Finally, as these topics raise complex problems, they often require time and trust to be solved. Time can be shortened if the MEU negotiators agree to look at similar agreements already concluded between Chile (or Mexico) and the EU on such topics, and to check whether, *mutatis mutandis*, those agreements could not be adapted to Mercosur members willing to negotiate on such issues.

This list also includes environmental issues, such as those related to climate change (Viola, 2013), energy (Brazil is doomed to become a major oil producer (de Oliveira, 2012)), research, industrial cooperation and the transfer of technology (a topic high on the Brazilian agenda (Flôres, 2013)) and cooperation at the borders (customs administration, trade facilitation and visas for workers).

Identifying the most efficient instruments of negotiation

A key issue in the current EU–Mercosur negotiations is that each side – negotiators and markets – has lost trust in the process (and often in the other partner). The first goal for keeping the negotiations on track is to re-create such trust by delivering substantive results. Such a goal requires a careful choice of the instruments of negotiations. The history of trade negotiations shows that such instruments can make a lot of difference. For instance, the simple formula of annual and equal cuts on all the goods with no exception included in the Treaty of Rome (1957) has proven a very efficient way to dismantle the tariffs among the founding EU member states – despite the deep differences among these countries on the role of trade in growth (with Germany and Benelux countries being convinced of trade as an engine of growth, and France and Italy being quite sceptical), and indeed to the great surprise of most observers at the time.¹

¹ There were two exceptions to this rule: bananas and green coffee, with bananas having been the source of a long list of disputes between the EU and certain trading partners.

Since a major field of potential agreements to be successfully negotiated by Mercosur and the EU in the current context consists of norms and more generally regulations, what follows focuses on defining the most efficient way to negotiate in terms of regulations, that is, the 'mutual recognition' approach.

The mutual recognition principle was articulated in the 1979 ruling on the *Cassis de Dijon* case by the European Court of Justice (Messerlin, 2011). It gave birth to two operational forms:

- Mutual recognition can be 'conditional' upon a core of common principles to be defined by negotiations among the trading partners. This form has been the traditional approach of the EU following the 1979 Court ruling. Initially, this approach raised huge hopes of solving the problem created by the insurmountable difficulties of harmonising the existing regulations of the EU member states. But, conditional mutual recognition has rapidly shown its limits: many forces (from political pressures to anti-competitive business pressures) have induced an expansion of the core conditions to the point that mutual recognition has become increasingly similar to harmonisation (the situation that the EU wanted to escape). In the meantime, conditional mutual recognition did not succeed in creating trust among EU member states – some member states accuse others of using mutual recognition as a way to practice 'regulatory dumping' by offering 'cheap' substitutes – or in enforcing EU regulations.
- Alternatively, mutual recognition can be defined as being 'unconditional': the two signatories feel that they trust each other and their respective regulations enough to be able to recognise unconditionally the partner's regulations. An essential element of unconditional mutual recognition is to require systematically a preliminary step – that is, a joint process of mutual evaluation of the regulations in question by the negotiating partners. This step of mutual regulatory review does not exist in the conditional mutual-recognition approach. But it is crucial, because it offers the unique opportunity to build, or restore, trust among the signatories. Moreover, such a step requires the participation of the regulating bodies of the negotiating countries – not only from the traditional trade negotiators (such as the Directorate-General for Trade in the EU case). Enlarging the set of 'negotiators' to skilled 'evaluators' should also be seen as an opportunity to create some dynamism in the trust among negotiators, and more broadly among consumers from all the negotiating countries.

The EU is still being torn apart between conditional mutual recognition (the dominant principle in norms and standards, with the ACAAs² and their increasingly tight regulations, and the dominant principle in services during the 1980s and 1990s), and the unconditional mutual-recognition approach (the principle driving the EU Services Directive).

Meanwhile, the emerging part of the world challenges this situation. It would be naïve to assume that a conditional mutual-recognition approach so prone to shifting to harmonisation is a workable principle in the coming mega PTAs (with the US, Japan or Taiwan-China). No partner to such a PTA would be in a position to impose its own version of conditional mutual recognition ('own version' meaning de facto a recognition biased towards harmonisation to its own regulations).

² ACAAs refer to Agreements on Conformity Assessment and Acceptance of Industrial Products.

In this broad context, EU–Mercosur negotiations on norms relying on the unconditional mutual-recognition approach would be the best option to consider, all the more because it has two additional advantages. First, such negotiations can be easily held in a bilateral setting (Brazil–EU, Argentina–EU, etc.), giving Mercosur members the needed flexibility. Second, the negotiating teams (trade and regulatory experts) can be kept small.

Concluding remarks

This paper has stressed the long-term natural ‘partnership’ that has emerged between Brazil and the EU in trade during the two last decades. Yet Brazil (and much more some of its Mercosur partners) has expressed strong reluctance to use trade as an engine of growth. At the same time, the EU needs urgently to conclude trade agreements with countries large enough, well regulated enough and well enough connected to the rest of the world to boost its own growth and to make politically sustainable its macroeconomic and fiscal policies. It also needs to move urgently in order to insure itself against the discriminatory impacts of the other emerging ‘mega PTAs’. In the coming decade or so, Brazil does not fulfil these criteria.

This divergence between Mercosur’s mood on trade and the EU’s desperate need for rapid growth and insurance leaves little hope for a successful conclusion of a fully-fledged Mercosur–EU PTA. By contrast, the paper argues that a lot can be done on crucial matters: norms in goods, possibly regulations in some services, climate change, energy, technology and some regulatory cooperation. Successful negotiations on these topics would not change dramatically the current level of market access. But they would create the much needed trust between the two sides of the Atlantic and they would magnify the results in terms of market access that could be achieved once the Mercosur members and the EU are in the same mood.

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